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Determinant of financial performance of rural banks in Indonesia

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Abstract
Rural banks (BPRs) are one of the financial institutions that play an important role in the economic development in Indonesia; particularly in the increasing productivity of the real sector, especially for micro, small and medium enterprises. While the existence of BPRs in the midst of domination of commercial banks is widely regarded necessary, many BPRs experience difficulties in enhancing their financial performance. The purpose of this study is to examine the factors potentially influence the financial performance of BPRs operating in Jakarta province. The results of this study indicate that the loan to deposit ratio has no significant effect on the financial performance of BPRs operating in the province. Furthermore, it was found that the ratio of non-performing loans had a negative and significant effect on the financial performance of conventional rural banks. The capital adequacy ratio had a positive and significant effect on the financial performance of conventional rural banks. Finally, it was found that operating expense ratio has a negative and significant effect on the financial performance of conventional rural banks.

Keywords: financial performance, rural banks, Indonesia

1. Introduction
The Bank is one of the financial institutions that plays an important role in the economic development of a nation (Berger, 1995) [7]. The Bank is an intermediary institution as well as a direct driver in the real sector. In the Indonesian context, banks could be divided into two, namely commercial banks and rural banks (hereinafter BPRs). The existence of rural banks in the midst of domination of commercial banks is very necessary because it has a special market to increase the productivity of the real sector, especially for micro, small and medium enterprises. The development of conventional BPRs in Jakarta Province of Indonesia is quite significant. Until 2017, the number of conventional BPRs operating in the province reached 42 banks. The rapid banking business in the province has made these banks must always maintain their financial performance so that it does not cause problems in their operational activities. In general, the financial performance of conventional BPRs operating in the province, as seen from the return on assets (ROA) ratio, over the past five years shows a relatively safe condition.

Literature shows that the ROA can be influenced by several factors, including internal bank factors, macroeconomic conditions, and creditor and debtor factors. According to Appiah *et al*. (2015) [4], one of the factors that influence the ROA is the level of operational efficiency measured by the ratio of operating costs to operating income (OER). A high OER level indicates that bank business activities are inefficient; the bank's operating income margin for operating costs is not optimal. The inefficiency of bank operations is caused by several factors, such as mismanagement due to the low quality of human resources owned, ineffective product marketing, high operating costs due to the non-strategic interest system and bank location. In contrast, a low OER level indicates that the bank is able to optimize its operating income margin over its operating costs. In addition, banks are also able to use their resources efficiently.

In addition to the efficiency level factor, another factor that is considered to affect the financial performance of a bank is the non-performing loan (NPL). Literature in general shows that the NPL can reduce bank income from the credit side (Chou and Buchdadi, 2016) [9]. Early research shows that some of the loans disbursed by conventional rural banks in Indonesia have relatively low collectability. A high level of NPL can reduce the level of bank liquidity, which has an impact on the decline in the bank's ability to cover operational costs at the expense of deposit rates and bank capital adequacy. The inability of banks to pay their obligations will reduce customer confidence in the bank and decrease the bank's financial performance.

Other factors that can affect the bank's financial performance are the level of capital adequacy and the amount of credit disbursement made by banks (Ahmed, 2013) [3]. With sufficient capital, the bank will have a great opportunity to use it for productive purposes, so that it will improve the bank's financial performance. On the other hand, credit expansion carried out by banks will obviously increase bank profitability in terms of credit (Awo and Akotey, 2012) [5]. If banks can maintain the level of capital adequacy and the level of credit disbursement without waiving the level of liquidity, then public confidence in the bank will increase. In addition, such conditions will also improve the bank's financial performance in terms of income. In general, the capital adequacy ratio (CAR) is used to measure the level of bank capital adequacy, while the loan to deposit ratio (LDR) is used to measure the level of lending and also the level of liquidity (Adusei, 2015) [1].

The purpose of this study is to examine the factors potentially

influence the financial performance of conventional rural banks in Indonesia, particularly conventional BPRs operating in Jakarta province. The region was chosen because Jakarta, as the capital city, is located in Jakarta Province. Many commercial banks, both local and international banks are operating in the Jakarta province area. Thus, it is interesting to examine how conventional BPRs attempted to improve their financial performance amid increasingly competitive competition between banks.

2. Literature review and hypotheses development

2.1 Return on Assets

Return on Assets (ROA) is a profitability ratio that shows the percentage of net income obtained by the company in relation to the overall resource or average number of assets. In other words, ROA is a ratio that measures the level of efficiency of a company in managing its assets to generate profits during a certain period. According to Jamal, *et al*. (2012) [12], this ratio is obtained by dividing the company's net income (usually annual income) with its total assets and is displayed in the form of a percentage. The general way of calculating ROA is to calculate the total assets on a certain date or by calculating the average total assets. According to Pasiouras and Kosmidou (2007) [20], the main purpose of asset usage is to generate income and profits for the company. This ROA ratio can help management and investors to see the level of ability of a company to convert its investment in assets into profit. The ratio is also could be considered as the level of return on investment because capital assets in general are often to be the biggest investment.

Specifically, Demirguc-Kunt and Huizinga (1999) [10] emphasizes that the ROA ratio varies in different industries. In this perspective, capital-intensive industries will produce a low ROA ratio because these industries require expensive assets to conduct their business. Meanwhile, non-capital-intensive industries will generate a high ROA ratio because these industries do not require expensive assets. Therefore, this ROA ratio is more appropriately used to compare companies engaged in the same field or to compare company performance from one period to the next. The ROA ratio is useful to measure the level of efficiency of a company in changing the money used to buy assets into net income. A higher ratio indicates that a company is more effective in managing its assets to generate a greater amount of net income. ROA will be useful to compare companies engaged in the same industry because different industries will use different types of assets in carrying out their operations.

2.2 Operating expenses ratio

All operational activities of a bank will definitely require operating expenses. Referring to Kosmidou (2008) [14], bank operational costs are all expenses incurred to finance the banks business activities. These operating expenses include interest expense, loss on commitments and contingencies, write-down of earning assets and other expenses related to the banks business activities. Operational costs and operating income are interconnected. If income is greater than operating costs, then the company will get greater profits. A company must be able to control its operating costs. The ratio of operating costs to operating income (OER) has an impact on the company's financial performance. Lee and Hsieh (2013) [15] state that OER can be used to measure the level of efficiency and ability of banks in running their operational activities. For this reason, the bank must do a comparison between the amount of operational costs and its operating income.

Furthermore, in the banking industry, the operating income is the interest earned from the customer while the operating costs are the interest earned from the third parties. This bank income will be better if the interest cost is small, suggesting that the bank must be good at choosing the third party. In general, the party who provides their funds to banks demand a higher interest; causing the banks to become more critical in terms of the interest rates charged to their customers. Therefore, to get a large operating income, the bank is required to find a lot of customers and be able to reduce the interest costs.

Berger (1995) [7] highlights the importance of operational income factors for the development of performance and sustainability of a bank. This factor will be used to finance operational costs, improve bank performance and also for capital growth. Banks must not rely too much on third parties. Even if the bank receives a lot of credit applications, the bank still has to be selective, especially if the funds owned by the bank are limited. Berger further states that the operating income consists of all income obtained from direct operational activities that have actually been received. The operating income can be in the form of interest, commission and fees, income on foreign exchange transactions and other income. Interest income earned is the main income obtained from the distribution of bank funds to customers and income derived from bank investment to customers. The interest income can be obtained every month when customers pay their obligations to the bank while interest income from investments such as demand deposits, time deposits and bonds, this can be obtained monthly or annually.

According to Boyd and Runkle, (1993) [8], the performance of a bank can be determined based on a quantitative assessment of bank profitability as measured by using the ratio of operational costs to operating income. The ratio can be used to measure the level of efficiency and ability of a bank to conduct its operations. The ratio is also could be used to measure the ability of the bank's management to control operating costs against operating income. The ratio is calculated based on the sum of the total interest expense and the total other operating expenses. Operating income is the sum of total interest income and total other operating income. In this case, the smaller the ratio of operating costs means the more efficient operational costs incurred by the bank concerned.

2.3 Loan to Deposit Ratio

Adusei (2015) [1] states that the loan to deposit ratio (LDR) is the ratio between the amount of all credit distributed by banks and the amount of funds received from various sources. The ratio is a traditional measurement that shows time deposits, demand deposits, and savings used in fulfilling the loan requests requested by customers. This ratio is used to measure the level of liquidity. A high ratio of LDR indicates that a bank lends all its funds (loan-up) or is relatively illiquid.

Conversely, a low ratio shows liquid banks with excess capacity of funds that are ready to be lent. The LDR is also called the ratio of loans to total third party funds used to measure third party funds channeled in the form of credit.
According to Appiah *et al*. (2015) [4], credit distribution is the bank's main activity because the main source of a bank's income is derived from this activity. The greater the distribution of credit, the greater risk that must be borne by the bank concerned. The ratio illustrates the ability of banks to repay withdrawals made by customers by relying on loans provided as a source of bank's liquidity. The higher this ratio, the lower the banks liquidity capability. Ahmed (2013) [3] highlighted that an important goal of calculating LDR is to know and assess the level of the bank's ability to carry out its operations or business activities. In other words, LDR is used as an indicator to determine the level of vulnerability of a bank. Meanwhile, XXX (2000) explained that the LDR has an important role in the development of a bank. Therefore, the ratio has become one of the indicators for assessing the health level of banks.

2.4 Capital Adequacy Ratio

According to Jamal, *et al*. (2012) [12], capital adequacy ratio (CAR) is a ratio that shows the bank's ability to provide funds for business development needs and accommodate the possible risk of losses caused by bank operations. The greater the ratio, the better the capital position. According to Bank of Indonesia, a bank must provide a minimum capital of 8 percent of risk-weighted assets (RWA). The ratio also shows the total assets of a bank that contains the risk of being funded by their own capital in addition to obtaining funds from sources outside the bank. Chou and Buchdadi (2016) [9] argues that the CAR is a ratio that shows the banks ability to maintain sufficient capital and the ability of bank management to identify, measure, supervise, and control the risks that arise that can affect the amount of capital. The ratio calculation is based on the principle that every investment that contains a risk must be provided with a certain amount of capital in the amount of the investment.
In similar, Ahmed (2013) [3] suggested that CAR is a ratio in terms of capital adequacy. Thus, a deeper understanding of the ratio is an important step as an effort to anticipate if there is a loss in the bank. A bank may suffer losses due to various factors. Analysis of the ratio should remain a concern of the bank since its inception. In this case, a high CAR value indicates a good ability of banks to run the risk of various credit that may be at risk. In addition, a high CAR value indicates that banks are able to finance various operational activities and contribute maximally to matters relating to profitability. Accordingly, understanding the CAR concept and matters related to CAR is an important material that needs to be done by the bank. Understanding the banks financial performance through CAR will greatly help bank management in preparing themselves to anticipate a decrease in assets due to assets that are often at risk. By using the CAR value, bank management can predict the ability of the bank to cover all of these possibilities. The ratio shows the ability of banks to provide funds used to overcome possible risk of loss. This ratio is important because by keeping the CAR to a safe limit, it also means protecting customers and maintaining overall financial system stability. The greater the value of the CAR reflects the ability of banks to be better in the face of possible risk of loss. CAR can be obtained by dividing the total capital by risk-weighted assets.

2.5 Non Performing Loan

Non-Performing Loans (NPLs) can be referenced as a condition where the customer is unable to pay a part or all of his obligations to the bank as agreed or credit, whereas its collectibility is categorized in special mention, substandard, doubtful, and bad credit. The higher the NPL ratio, the lower the level of bank liquidity on third party funds as most of the funds channeled by banks are deposits of third parties. The classification of credit quality needs to be done so that the quality of productive assets can be observed so that the risk of inhibition of the bank's productive assets can be reduced. In determining credit quality, banks must pay attention to factors of business prospects, performance and ability to pay debtors (Mwinlaaru, *et al*., 2016) [17].
Furthermore, Ahmad and Ariff (2007) [2] suggest that NPL is one indicator of the healthy level of the bank. The ratio can provide information on capital conditions, profitability, credit risk, market risk and liquidation. Assessment of asset quality is a valuation of the condition of assets and the adequacy of credit risk management. It means that NPL is an indication of a problem arise in the bank. If this problem does not immediately get a solution, it will have a negative impact on lending in the next period. A high NPL indicates that the bank is unhealthy as it causes a decrease in profits to be received by the bank.
Referring to Fofack (2005) [11], there are many factors that led to NPLs, namely internal factors, external factors, and debtors. Internal factors are factors that come from the bank itself. Massive expansion of lending activities without standardization of analysis of prospective borrowers, non optimal supervision of the bank, determination of high lending rates, the amount of lending that exceeds the bank's ability to liquidate, and the weak ability of the bank to detect the possibility of non-performing loans are some of the main factors causing an increase in NPL. External factors include, among others, the influence of inflation and exchange rates, the effect of GDP per real capita, the existence of natural disasters and the influence of GDP levels, the decline in the country's monetary conditions and the existence of government regulations and other restrictive regulations which have a major impact on the financial and operational situation of the bank.

3. Research Methodology

3.1 Research design

This study uses quantitative analysis and secondary data in the form of time series and cross section data. Data used in this study were obtained from the statistics of Indonesian conventional rural banks. All variables used in this study represent the average ratio of conventional rural banks operating in Jakarta Province from January 2013 to December 2017. This study excluded a certain BPR from analysis if its financial reports is not available for all the periods.

3.2 Research variables

The variables being investigated in this study could be classified into two: independend and dependent variables. In this case, return on assets serve as dependent variable while operational expense ratio, loan to deposit ratio, capital adequate ratio, and non-performing loan serve as dependent variables. Table 1 shows the operationalization of the variables used in this study.

Table 1: Operationalization of the variables used in this study

Variables	Definition	Formula
Return on assets (ROA)	A ratio between the company earning and its total assets	(Net income / Total assets) x 100%
Operational expense ratio (OER)	A ratio between operational expense and operational revenue	(Operating expenses / Operating revenues) x 100%
Loan to Deposit Ratio (LDR)	A ratio between loan that is distributed and total deposit from the bank creditur	(Total loan / Total deposit) x 100%
Capital Adequate Ratio (CAR)	A ratio between the capital owned by bank and the assets of bank that bear the credit risk on it	(Bank capital / Risk weighted assets) x 100%
Non Performing Loan (NPL)	The amount money of loan that is in default or close to default	(Non performing loan / Total loan) x 100%

***Source*:** Chou and Buchdadi (2016) [9]

3.3 Model formulation

Based on classification of the variables being investigated, this study formulate the model of the study as follow. Following previous studies, this study applied a panel data regression analysis in the calculation of data.

$$Y = \beta_0 + \beta_1 OER + \beta_2 LDR + \beta_3 CAR + \beta_4 NPL + \varepsilon$$

Where:
Y : return on assets
OER : operational expense ratio
LDR : loan to deposit ratio
CAR : capital adequate ratio
NPL : non-performing loan

4. Result and Discussion

Table 1 presents the results of descriptive statistics for the variables being investigated in the study: ROA, OER, LDR, CAR, and NPL. The descriptive statistics are presented in terms of mean, standard deviation, minimum value, and maximum value.

Table 2: Descriptive statistics of variables used in the study

Variables	N	Mean	Std. Dev	Min	Max
ROA	210	5.12	1.33	1.62	8.37
OER	210	76.55	14.38	47.91	93.64
LDR	210	88.42	12.76	61.58	118.43
CAR	210	8.51	1.84	4.96	12.17
NPL	210	6.28	1.51	3.64	14.73

As can be seen in Table 1, it was found that the value of return on assets (ROA) varied between 1.62 percent and 8.37 percent with a mean of 5.12 percent and a standard deviation of 1.33 percent. Operating cost efficiency (OER) ranged from 47.91 percent to 93.64 percent with a mean of 76.55 percent and a standard deviation of 14.38 percent. Loan to deposit ratio (LDR) ranged from 61.58 percent to 118.43 percent with a mean of 88.42 percent and a standard deviation of 12.76 percent. Capital adequacy ratio (CAR) ranged from 4.96 percent to 12.17 percent with a mean of 8.51 percent and a standard deviation of 1.84 percent. Lastly, non-performing loans (NPL) ranged from 3.64 percent to 14.73 percent with a mean of 6.28 percent and a standard deviation of 1.51 percent. The following is the result of the estimation model for five regions of Jakarta province during the period 2013 to 2017.

Table 3

	West Jakarta	East Jakarta	North Jakarta	East Jakarta	Central Jakarta
Constant	0.263	0.417	0.351	0.326	0.128
OER	- 0.132	- 0.264	- 0.225	- 0.143	- 0.118
LDR	0.046	- 0.082	0.105	0.053	- 0.077
CAR	0.362	0.331	0.248	0.257	0.315
NPL	- 0.112	- 0.231	- 0.175	- 0.223	- 0.146
Adj R^2	0.42	0.51	0.47	0.53	0.66
F	12.63	24.58	16.72	14.95	20.03

Based on the estimation model as presented in Table 2, an analysis can be made regarding the effect of LDR, NPL, CAR, and OER on the financial performance of conventional BPRs operating in the Jakarta Province of Indonesia. The analysis model shows that the LDR variable has a negative relationship to the financial performance of conventional rural banks although their effect is insignificant. The findings of this study support previous studies, which found that the LDR had no significant effect on bank ROA. In other words, the expansion of credit distribution does not necessarily encourage an increase in bank profitability considering that credit disbursement by BPRs is vulnerable to defaults by creditors. The findings of this study indicate that the average LDR of conventional BPRs operating in the Jakarta Province is lower than 88.42 percent. This ratio shows that most conventional BPRs have a high level of lending compared to the amount of third party funds collected.

Furthermore, this research found that NPL has a significant and negative influence on the financial performance of conventional BPRs. The finding of this study is in line with the results of previous studies which confirm that the NPL and the bank's financial performance are negatively related. The high NPL ratio shows that many BPRs fall in lending. This condition is reflected in the high level of non-performing loans, which means that the loans disbursed have low quality.

The existence of low credit quality will obviously reduce the bank's profitability due to the large reserve allowance for earning asset losses. The high NPL ratio requires banks to be more selective in determining their prospective borrowers, thereby reducing the distribution of bad loans by banks. The decrease in the quantity of bad loans will have a positive impact on bank income.

Next, results show that there is a positive influence of capital adequacy ratio on the financial performance of BPRs operating in the Jakarta Province. Literature shows that the capital adequacy ratio is the ratio used to measure capital adequacy and bank capacity in maintaining capital for its operational activities. Bank with sufficient capital will not experience difficulties in lending or to maintain the level of bank liquidity. Thus, the BPR will be better prepared to meet its short-term goals or for its long-term goals. The estimation model of this study confirms that the capital adequacy ratio has a positive and significant influence on the bank's financial performance. The result is in line with the results revealed by previous studies. The literature suggests that the amount of capital will obviously affect the amount of earning assets so that the bank's asset utilization will also increase. A high asset utilization will make it easier for BPRs to manage their assets and allow them to increase their profits. In addition, bank capital will also increase bank resilience in times of economic turmoil and can also increase public confidence in the bank itself.

Furthermore, the literature suggests that OER is a ratio that shows the level of success and quality of bank in terms of its operational management. The lower the OER ratio shows that banks can manage their assets to be more productive, thereby reducing their operating costs. In other words, the OER ratio is a ratio that shows the level of efficiency of a bank in its operational activities. This description is in line with the results of this study showing that the OER ratio has a negative and significant effect on the financial performance of conventional rural banks in the Jakarta Province region. The results of this study confirm some of the results of previous studies which stated that the level of bank efficiency, reflected in the OER ratio, had a negative and significant effect on the ROA ratio. This finding shows that if banks are more efficient in carrying out their operational activities (the OER ratio decreases), the financial performance of the BPR will be better (higher ROA ratio). Conversely, the BPR's financial performance will be low if the bank runs its operational activities inefficiently (high OER ratio). This condition can occur due to bank operating costs that are too large and cannot be overcome by operating income so as to reduce the profitability of the bank's own operational activities.

5. Conclusion

The results of this study indicate that the loan to deposit ratio has no significant effect on the financial performance of conventional rural banks operating in the Jakarta Province. Such conditions indicate that the expansion of lending cannot necessarily boost bank profitability. The findings of this study indicate that most conventional BPRs have a level of lending that is not too high compared to the amount of collected third party funds. Furthermore, it was found that the ratio of non-performing loans had a negative and significant effect on the financial performance of conventional rural banks. These findings confirm that non-performing loans and the bank's financial performance are negatively related. Thus, the bank needs to be more selective in determining its prospective borrowers so that it will reduce the distribution of bad loans by banks. The decrease in the quantity of bad loans will have a positive impact on bank income.

Then, this study found that the capital adequacy ratio had a positive and significant effect on the financial performance of conventional rural banks. CAR is a ratio that is related to capital adequacy and bank capacity in maintaining capital for its operational activities. It is generally understood that the level of capital of a bank will affect the amount of earning assets so that the bank's asset utilization will also increase. Sturdy bank capital will also increase bank resilience and public confidence in the bank. Finally, this study found that operating expense ratio has a negative and significant effect on the financial performance of conventional rural banks. This finding confirms that the level of bank efficiency has a negative effect on the BPR's financial performance. The negative relationship between operating expense ratio and financial performance of an RB may occur due to the inefficiency of the bank in running its business due to the bank's operating costs that are too large and cannot be overcome by operating income, thereby reducing the profitability of the bank's operational activities.

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